

# **Cancellation of Debt**

# Cancellation of Debt

Section 61(a)(12) of the Internal Revenue Code provides that gross income includes “income from discharge of indebtedness.”

# Cancellation of Debt

## Example:

Taxpayer A borrows \$10,000 from Bank X in 2006. When the loan comes due in 2007, Taxpayer A is able to repay only \$8,000. Bank X discharges the remaining \$2,000. Taxpayer A has \$2,000 of cancellation of debt (COD) income.

# Cancellation of Debt

Section 6050P of the Internal Revenue Code requires certain financial institutions and federal agencies that cancel a debt of \$600 or more during any calendar year to file an information return (Form 1099-C) with the IRS and provide a copy to the taxpayer whose debt was cancelled.

# COD income can arise in various contexts, including:

- Cancellation of credit card debt
- Cancellation of automobile debt
- Cancellation of student loan debt
- Cancellation of home mortgage debt

# Cancellation of Debt

If a debt for which the taxpayer is personally liable is discharged as a result of a foreclosure, sale, or other disposition of property that secures the debt, the taxpayer may realize gain or loss on the disposition as well as COD income.

# Cancellation of Debt

## Example:

Taxpayer A purchased his home for \$200,000, paying \$15,000 down and borrowing the remaining \$185,000 from Bank X. The loan is secured by the house, but Taxpayer A is personally liable for repayment of the loan. When Bank X forecloses on the loan, the balance due is \$180,000 and the fair market value of the house is \$170,000. Taxpayer A's adjusted basis in the house is \$200,000.

# Cancellation of Debt

## Gain or Loss on Foreclosure:

Amount Realized	\$170,000 (FMV)
Adjusted Basis	<u>200,000</u>
Loss on Foreclosure	\$ 30,000



# Cancellation of Debt

## COD Income:

Amount of debt discharged	\$180,000
FMV of house upon foreclosure	<u>170,000</u>
Cancellation of debt income	\$ 10,000

Section 108 excludes discharges of indebtedness from gross income if:

- The discharge occurs in bankruptcy
- The discharge occurs when the taxpayer is insolvent
- The debt is “qualified farm indebtedness”
- The debt is a student loan for which the exclusion provided by section 108(f) applies

# Insolvency Exception

A taxpayer is insolvent to the extent that the taxpayer's liabilities immediately before the discharge exceed the fair market value of the taxpayer's assets immediately before the discharge. The amount excludable under the insolvency exception is limited to the amount by which the taxpayer is insolvent.

# Insolvency Exception

## Example:

Taxpayer A has COD income of \$10,000. Immediately before the debt discharge, Taxpayer A's liabilities totaled \$175,000 and the fair market value of his assets totaled \$169,000. Thus, Taxpayer A is insolvent to the extent of \$6,000, and may exclude \$6,000 of the COD from income under the insolvency exception.